

**Internal Revenue Service
Appeals**

Number: **201022030**
Release Date: 6/4/2010

March 12, 2010

Uniform Issue List

501.03-00

Department of the Treasury

Address any reply to:

Employer Identification Number:

Form Number:

990-PF

Person to Contact:

Contact Telephone Number:

Fax Number:

**Last Day to File a Petition with the United States
Tax Court:**

JUN 10 2010

Certified Mail

Dear :

This is our final adverse determination as to your exempt status under section 501(c)(3) of the Internal Revenue Code ("Code"). It is determined that you do not qualify as exempt from Federal income tax under IRC section 501(c)(3) effective January 1, 20XX.

Our adverse determination was made because **** is not organized and operated exclusively for an exempt purpose within the meaning of Code section 501(c)(3).

Contributions to your organization are not deductible under Code section 170.

You are required to file Federal income tax returns on form 1120 for any years which are still open under the statute of limitations. Based on the information you furnished, it appears that returns should be filed beginning with the year ending December 31, 20**. You are required to file converted Forms 1120, U.S. Corporation Income Tax Return, for any years which are still open under the statute of limitations. Returns for tax years ending December 31, 20**, December 31, 20**, and December 31, 20** should be sent to Internal Revenue Service

no later than March , 20 . Forms 1120 for tax periods beginning on and after January 1, 20 should be filed with the ****.

We will notify the appropriate State officials of this action, as required by Code section 6104(c). You should contact your state officials if you have any questions about how this determination may affect your state responsibilities and requirements.

You have waived your right to contest this determination under declaratory judgment provisions of Section 7428 of the Code by your execution of Form 906, Closing Agreement Concerning Specific Matters, an executed copy of which is being sent to you under separate cover.

You also have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures such as the formal appeals process.

The Taxpayer Advocate is not able to reverse legally correct tax determinations, nor extend the time fixed by law that you have to file a petition in the U.S. Tax Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. If you want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. See the enclosed Notice 1214, *Helpful Contacts for Your "Notice of Deficiency"*, for Taxpayer Advocate telephone numbers and addresses.

If you have any questions, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely yours,

/s/

Appeals Team Manager

Enclosure:

Notice 1214 Helpful Contacts for your "Notice of Deficiency"

cc: ****



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY

Internal Revenue Service

ATTN: Dayo Adesuyi/Fred Kluss
N14 W24200 Tower PL., Suite 202
Waukesha, WI 53188

OCT 29 2008

Legend

ORG= Name of organization

x=Date

X= Year

ORG

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

December x, 200X, 200X and 200X

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

Certified Mail - Return Receipt Requested

Dear :

We have enclosed a copy of our report of examination explaining why we believe revocation of your exempt status under section 501(c)(3) of the Internal Revenue Code (Code) is necessary.

If you accept our findings, take no further action. We will issue a final revocation letter.

If you do not agree with our proposed revocation, you must submit to us a written request for Appeals Office consideration within 30 days from the date of this letter to protest our decision. Your protest should include a statement of the facts, the applicable law, and arguments in support of your position.

An Appeals officer will review your case. The Appeals office is independent of the Director, EO Examinations. The Appeals Office resolves most disputes informally and promptly. The enclosed Publication 3498, *The Examination Process*, and Publication 892, *Exempt Organizations Appeal Procedures for Unagreed Issues*, explain how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process.

You may also request that we refer this matter for technical advice as explained in Publication 892. If we issue a determination letter to you based on technical advice, no further administrative appeal is available to you within the IRS regarding the issue that was the subject of the technical advice.

Letter 3618 (04-2002)
Catalog Number 34809F

If we do not hear from you within 30 days from the date of this letter, we will process your case based on the recommendations shown in the report of examination. If you do not protest this proposed determination within 30 days from the date of this letter, the IRS will consider it to be a failure to exhaust your available administrative remedies. Section 7428(b)(2) of the Code provides, in part: "A declaratory judgment or decree under this section shall not be issued in any proceeding unless the Tax Court, the Claims Court, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted its administrative remedies within the Internal Revenue Service." We will then issue a final revocation letter. We will also notify the appropriate state officials of the revocation in accordance with section 6104(c) of the Code.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free _____ and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Vickie L. Hansen
Acting Director, EO Examinations

Enclosures:
Publication 892
Publication 3498
Report of Examination

| | | |
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| Form 886A | Department of the Treasury - Internal Revenue Service Explanation of Items | Schedule No. or Exhibit |
| Name of Taxpayer ORG | | Year/Period Ended December 31, 20XX December 31, 20XX December 31, 20XX |

LEGEND

ORG = Organization name XX = Date TRU-1 & TRU-2 = 1st & 2nd Trustees CO-1 = 1st company

Primary Issue:

1. Whether a Private Non-Operating Foundation exempt under IRC Section 501(c)(3), should retain their exempt status?

Facts:

The ORG (ORG) was recognized as a Private Non-Operating Foundation, exempt under IRC Section 501(c) (3), on October 9, 20XX. TRU-1 and TRU-2 are the creators and trustees of the ORG.

The examination of the ORG, for the years ending December 31, 20XX, 20XX, 20XX and 20XX, resulted in several Chapter 42 assessments. The assessments were for self-dealing (IRC Section 4941) against TRU-1 and CO-1 (the trustees own % of the company) and taxable expenditures (IRC Section 4945) against the ORG.

The transactions giving rise to the Chapter 42 assessments included a trip to _____ for the trustees of the foundation, extensions of credit between the ORG and CO-1 (The records provided show that the ORG has loaned CO-1 more than \$\$ from 20XX - 20XX), undocumented transfers to CO-1, and scholarship grants made to individuals related to or acquainted with the trustees of the foundation. The loans between the ORG and CO-1 were all unsecured, oftentimes with no principal or interest due for several years (Balloon Notes).

In terms of the trip to _____, the trustees of the ORG held a family meeting for the trust in _____; the trustees' children attended the meeting. The expenses the ORG paid for the trip included passes to _____, plane tickets, car rental, food and other personal items. It has been determined that the expenses paid for the trip to _____, at least in part represented the assets of the foundation, inuring to the benefit of the trustees of the ORG.

In terms of the loans made to CO-1, the loans were oftentimes precipitated by donations to the ORG from the trustees. For instance on November 30, 20XX the records provided by the organization show that the trustees made an \$\$ donation. On December 9, 20XX the records show a loan of \$\$ made to CO-1 and \$\$ in compensation paid to the trustees. Similarly in

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| | | December 31, 20XX |
| | | December 31, 20XX |

December of 20XX, the record shows \$\$ in donations by the TRUSTEES's followed by a \$\$ loan to CO-1.

The trustees claimed the amounts given to the ORG on their tax return as tax-deductible contributions. Thus these in-and-out transactions provided the trustees the opportunity to seek the benefits of a tax-deductible donation, while at the same time providing their company, CO-1 access to capital.

CO-1, privately benefited from the loan transactions. Due to their relationship with the ORG they were able to access funding and negotiate long-term repayment plans on unsecured debt with the ability to renegotiate. For instance a loan made on March , 20XX in the amount of \$ was due from CO-1, one year from the date of origination or March , 20XX (Principal and interest was to be paid on the date the loan was due). This loan was later extended by both parties with the due date of March , 20XX. As of the date of the report, this and the majority of the other loans have not been repaid.

In addition there was an instance in which \$ was transferred outside of the ORG to an outside account. The organization in providing documentation during the examination provided inadequate records. The general ledger did not originally reflect the transaction and the loan documentation provided showed the ORG to be the borrower, which was contradictory to the flow of funds. Based on the documentation provided this transaction was treated as a transfer of assets to CO-1.

The scholarships (approximately \$) provided by the ORG in 20XX, were to individuals related to or acquainted with the trustees. The ORG in awarding the grants also paid travel expenses for the trustees for a scholarship ceremony held in honor of some of the grant recipients. Part of the criteria the organization used to administer the grants included the fact that the recipients had to be related to the trustees of the foundation. This program was found to be administered in violation of IRC Section 4945. IRC Section 4945 provides that grants made to individuals must be made on a non-discriminatory basis; the applicant pool must be broad and there must be no bias in the selection process. Scholarships extended to related parties is evidence of private benefit.

In comparing the record of private benefit to charitable activity, the record shows a cumulative total of less than \$ in contributions made to unrelated charitable organizations during the years ending December 31, 20XX - 20XX. This is an insubstantial amount in comparison to the more than \$ extended to related parties (Through loans, grants and trip reimbursements).

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Overall, the provisions governing organizations exempt under IRC Section 501(c)(3) prohibits charitable organizations from allowing their assets to inure to the benefit of any individual or entity. Violation of the provisions is grounds for revocation.

Law:

IRC Section 501(c)(3)

Provides exemption for Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

Treasury Regulation Section 1.501(a)-1(c)

The words "private shareholder or individual" in section 501 refer to persons having a personal and private interest in the activities of the organization.

Treasury Regulation Section 1.501(c) (3)-1(c) (2)

Distribution of earnings. —An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals. For the definition of the words "private shareholder or individual", see paragraph (c) of §1.501(a)-1.

Treasury Regulation Section 1.501(c) (3)-1(d) (1) (i)

An organization may be exempt as an organization described in section 501(c) (3) if it is organized and operated exclusively for one or more of the following purposes:

(a) Religious,

(b) Charitable,

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- (c) Scientific,
- (d) Testing for public safety,
- (e) Literary,
- (f) Educational, or
- (g) Prevention of cruelty to children or animals.

Treasury Regulation Section 1.501(c)(3)-1(d)(1)(ii)

An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

IRC Section 509(b) provides that if an organization is a private foundation (within the meaning of subsection (a)) on October 9, 1969, or becomes a private foundation on any subsequent date, such organization shall be treated as a private foundation for all periods after October 9, 1969, or after such subsequent date, unless its status as such is terminated under section 507.

Treasury Regulation 1.509(b)-1(b) provides that if an organization is a private foundation on October 9, 1969, and it is determined that it is not exempt under section 501(a) as an organization described in section 501(c)(3) as of any date after October 9, 1969, such organization, even though it may operate thereafter as a taxable entity, will continue to be treated as a private foundation unless its status as such is terminated under section 507. For example, X organization is a private foundation on October 9, 1969. It is subsequently determined that, as of July 1, 1972, X is no longer exempt under section 501(a) as an organization described in section 501(c)(3) because, for example, it has not conformed its governing instrument pursuant to section 508(e). X will continue to be treated as a private foundation after July 1, 1972, unless its status as such is terminated under section 507. However, if an organization is not exempt under section 501(a) as an organization described in section 501(c)(3) on October 9, 1969, then it will not be treated as a private foundation within the meaning of section 509(a) by reason of section 509(b), unless it becomes a private foundation on a subsequent date.

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IRC Section 6033(d) provides that the following organizations shall comply with the requirements of this section in the same manner as organizations described in **section 501(c)(3)** which are exempt from tax under **section 501(a)**:

NONEXEMPT CHARITABLE TRUSTS. — A trust described in **section 4947(a)(1)** (relating to nonexempt charitable trusts).

NONEXEMPT PRIVATE FOUNDATIONS. — A private foundation which is not exempt from tax under **section 501(a)**.

IRC Section 4941(d)(1)(B) provides that self-dealing means any direct or indirect lending of money or other extension of credit between a private foundation and a disqualified person.

IRC Section 4941(d)(1)(E) provides that the term "self-dealing" means any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

IRC Section 4945(d)(3) provides the definitions of taxable expenditures. The expenditures include amounts paid or incurred by a private foundation as a grant to an individual for travel, study, or other similar purposes by such individual, unless such grant satisfies the requirements of subsection (g)

IRC Section 4946(a)(1) For purposes of this subchapter, the term "disqualified person" means, with respect to a private foundation, a person who is —

4946(a)(1)(A) a substantial contributor to the foundation,

4946(a)(1)(B) a foundation manager (within the meaning of subsection (b)(1)),

4946(a)(1)(C) an owner of more than 20 percent of —

4946(a)(1)(C)(i) the total combined voting power of a corporation,

4946(a)(1)(C)(ii) the profits interest of a partnership, or

4946(a)(1)(C)(iii) the beneficial interest of a trust or unincorporated enterprise,

which is a substantial contributor to the foundation,

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4946(a)(1)(D) a member of the family (as defined in subsection (d)) of any individual described in subparagraph (A), (B), or (C),

4946(a)(1)(E) a corporation of which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power,

4946(a)(1)(F) a partnership in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the profits interest,

IRC Section 4946(b)(1) provides that the term "foundation manager" means, with respect to any private foundation is an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation)

Revenue Procedure 84-46, 1984-1 CB 541

Where there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of an organization, revocation or modification will ordinarily take effect as of the date of such material change.

Rueckwald Foundation, Inc. v. C.I.R. Tax Court 1974 T.C. Memo 1974-298

The revocation of the Private Foundation's exemption under IRC Section 501(c)(3) was upheld. The Private Foundation in this case was found to have allowed a substantial part of their income to benefit private individuals through using a majority of its assets for the payment of personal expenses, including the payment of college, nursing and automobile expenses to individuals that were somehow related to the Private Foundation's trustee. The Private Foundation in this case was also shown to have performed little activity outside of paying the personal expenses of related individuals and holding title to and collecting rents from assets held in the Private Foundation's name. The case outlines the fact that a Private Foundation must not substantially use its assets in a non-exempt fashion nor engage in a substantial amount of non-exempt activity.

Government's Position:

TRU-1 and CO-1 are private shareholders of the ORG as described in Treasury Regulation 1.501(c)(3)-1(c)(2) and 1.501(a)-1(c). TRU-1 and CO-1 are also disqualified persons, as defined in IRC Section 4941. As assets of the ORG were transferred to TRU-1 through payment for a family trip, and as multiple loans were extended from the ORG to TRU-1, the provisions of IRC Section 4941 were violated. In addition the ORG violated the provisions of IRC Section 4945 by

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making scholarship grants in a manner that did not satisfy the requirements of IRC Section 4945(g), by providing scholarships to related parties.

It is our contention that the private benefit involved in the provision of loans, trip expenditures and scholarship grants by the ORG to related parties, not only violated the provisions of Chapter 42, but also violated the provisions of IRC Section 501(c)(3). The record shows that the majority of the ORG's income and/or assets was extended as credit to CO-1 with terms that left the Private Foundation without adequate access to its assets due to the balloon payment structure of the loans. In addition the record shows that the majority of these loans have not been repaid as required. In comparison there was very little record of amounts extended to outside parties in a manner that meets the legal definition of charitable as defined in IRC Section 501(c)(3) and Treasury Regulation 1.501(c)(3).

The fact that the ORG violated IRC Section 501(c)(3) by allowing their assets to inure to the benefit of private parties, is the primary reason for proposing revocation of their exempt status. Cases such as *Rueckwald Foundation v. C.I.R.* (U.S. Tax Court 1974), validate this conclusion.

The Court, in applying the private benefit doctrine, measured the amount of assets that served private interests versus charitable purposes, and the amount of exempt activity conducted by the Private Foundation in comparison to the non-exempt activity. In making its measurements, the court found that the Private Foundation failed to show that it was organized and operated to meet charitable purposes; thus the revocation of the Private Foundation's exempt status was upheld in this case.

In using the Court's measurements for purposes of our case, it was found that more than 90% of the ORG's assets were used in a way that privately benefited related individuals and/or entities.. In addition a substantial amount of the organization's activities included engaging in credit transactions, maintaining an uncharitable scholarship program (based on the fact that the program failed to meet the requirements of IRC Section 4945(g) and accompanying regulations), and authorizing and reimbursing trustee trips where personal expenses were involved.

Taxpayer's Position:

Taxpayer indicated that there was not a purposeful diversion of the corpus or income of the organization. Thus their position is that the 501(c)(3) status of the ORG should remain.

Conclusion:

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After reviewing all the facts, law, and positions of the parties involved, it has been determined that the exempt status of the ORG should be revoked. In accordance with Revenue Procedure 1984-46, the effective date of revocation is the date the material change in exempt status was noted, which in this case is January 1, 20XX.

IRC Sections 509 and 6033, and Treasury Regulation 1.509(b)-1(b), provide that a private foundation that has had their exempt status revoked, is a taxable private foundation. This change in status does not affect the Foundations or any disqualified person's liability for the Chapter 42 taxes. The organization is still subject to the excise taxes under Chapter 42 as a taxable private foundation.

As a taxable private foundation the organization is required to regularly file both Forms 990-PF and 1041; in preparing Form 1041 the ORG should not deduct any expenses or transfers that were personal use expenditures (Such as the \$ transfer or the \$ reimbursement-See IRC Section 162 for more details) Form 4720 is required to be filed if the organization engages in any future transactions that result in the violations of Chapter 42 of the code. Future violations of this Chapter, however, could result in the termination of the Foundation. The rules for terminating a private foundation are found in IRC Section 507. Part of the termination rules would require that the net assets of the foundation be transferred to a qualifying public charity, exempt under IRC Section 501(c)(3).